THE RF EARNINGS OUTLOOK | Q3 2019

Resolution Foundation

Look beyond the headline data on the forces behind current developments in pay, how the fruits are shared, and the short- and longer-term drivers of earnings growth

Unlike our politics, 2019 was a year of strength and stability in the labour market – a year when employment reached and stayed at record highs and pay growth neared pre-recession levels. The most recent set of labour market data (for the three months to October) underlined this – the 16-64 employment rate ticked up to a new record high of 76.2 per cent, while annual growth in real weekly pay (excluding bonuses) remained at a reasonably healthy 1.8 per cent.

Can 2020 repeat the same trick? Both our Spotlight piece (on page 4) and the Lifting the Lid charts (on page 2) assess the case for optimism heading into the new year. There are several clouds on the horizon in the shape of falling vacancies and slowing economic growth (both here and across the world), which are feeding into weaker demand for labour. This seems reason enough to think that the labour market will weaken next year.

But importantly, there is reason to be optimistic too. For one, employment is so high that, even if things do start to turn, we will still have a tight labour market for most of the year. This will maintain pay pressure which, coupled with below-target inflation should see real pay growth hold up for the time being.

Apart from looking to next year, December is also a time for celebration, and the Office for National Statistics (ONS) handed labour economists an early Christmas present in the shape of real-time data from PAYE records. This data will enrich our understanding of the labour market. Up until now we have largely been limited to understanding what's happening to average (mean) pay, with information on typical (median) pay, or pay for low earners, only coming once a year (via the Annual Survey of Hours and Earnings) and with a half-year lag. We can already see in the data, for example, that the softening in pay growth in the latter half of 2019 is not just happening at the mean – typical pay has followed the same pattern. The ONS's monthly labour market stats days will be (even more) exciting next year.

– Our **earnings breakdown** shows that real pay growth has plateaued just below pre-crisis levels, with growth of 1.8 per cent in the latest data.

– Our analysis of **pay pressures and slack** shows that the labour market is tight but (on headline measures) has stopped tightening. Employment is at a record high, and unemployment a record low. Underemployment fell by 11 per cent in the last year and is close to historic lows.

– Our review of **longer-term labour market health**, as usual, shows areas of concern. Productivity growth is very low, as is the level of workplace training.

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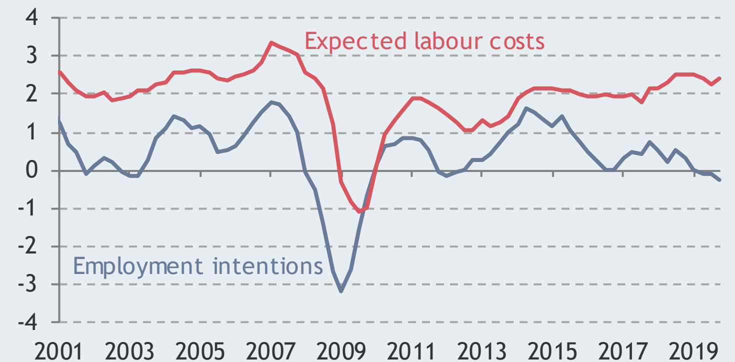
Lifting the lid: The picture across different groups and areas

Here we explore a few of the most interesting developments for different groups of workers and different parts of the country. A comprehensive breakdown of each indicator is available online: resolutionfoundation.org/earningsoutlook

Firms' expectations for their employment level in the next year have weakened

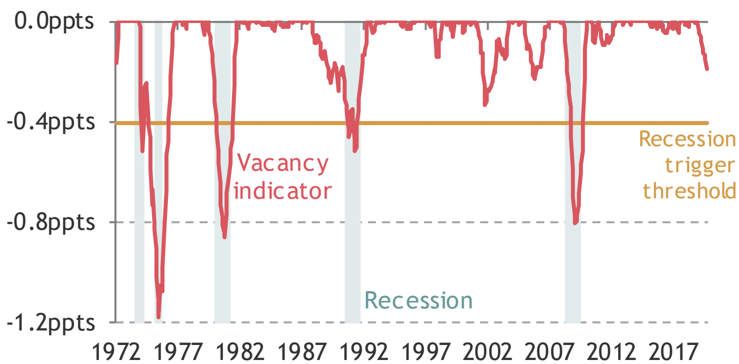
The Bank of England Agents collect information from firms about the expected change to the size of their workforce over the next year. This measure shows that employment growth is expected to weaken and is now at a level consistent with previous periods of stagnation in the labour market (e.g. early 2012). In contrast, labour costs (of which wages are the most material) are expected to increase. Labour costs lag employment intentions by three to four quarters in this data, suggesting that this employment stagnation can be consistent with sustained pay growth in the short term.

FIGURE 1: **Business expectations for employment and labour costs: UK**



NOTES: The employment score refers to planned and possible changes in the size of companies' UK-based workforces over the next 12 months, with a higher score indicating increasing employment. Data before end-2017 are spliced on using historic versions of the series.
SOURCE: RF analysis of Bank of England, *Agents survey*

FIGURE 2: **Difference between current vacancy rate and the highest vacancy rate in the prior 12 months: UK**



NOTES: Recessions are defined as two quarters of negative GDP growth. Historic vacancy data are based on spliced series from jobcentres and employment offices.
SOURCE: RF analysis of ONS, *Vacancy Survey*; Bank of England, *A millennium of macroeconomic data for the UK*

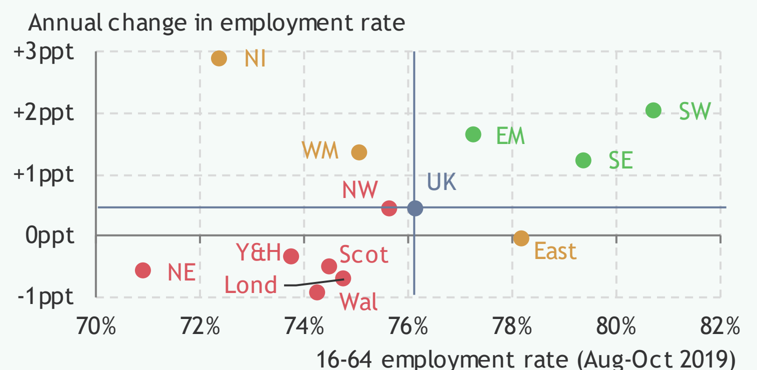
Recent falls in vacancies are moderate compared to historic movements

Vacancies have been falling in the UK since the end of 2018. When vacancies are high the economy is performing well, which implies higher employment and faster pay growth, so the fall in vacancies is a concerning signal for the health of the UK labour market. Vacancies tend to fall as the as the economy enters a recession. Figure 2 puts the recent falls in perspective. It shows that there is no evidence as yet that a recession is underway but that the recent falls are reasonably large from a historical perspective – consistent with the labour market reaching a turning point. This signals limits to future employment and pay growth.

The regional perspective

There is a wide disparity in employment rates across the UK's regions and nations. Notably, gaps between high- and low-employment regions have increased over the past 12 months. For example, the North East of England has an employment rate about 10 percentage points lower than the South West – with the gap increasing by 2.5 percentage points over the past year. Six of the lowest-employment areas currently have slower-than-average employment growth, suggesting that they are not catching up with the highest-performing areas, while just two have faster-than-average growth. This may represent an early warning sign of a weakening labour market.

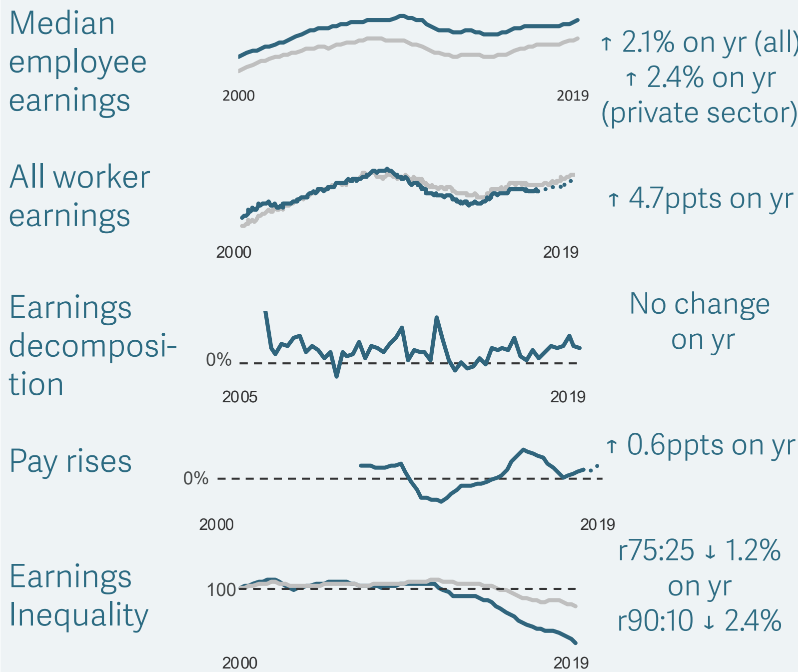
FIGURE 3: **Regional employment rate and change**



SOURCE: RF analysis of ONS, *Labour Force Survey*

The scorecard: Quarter 3 2019

What's happened: *The earnings breakdown*



In the most recent data, real median pay grew by 2.1%. This reflects both slowing inflation and higher nominal pay growth than a year earlier.

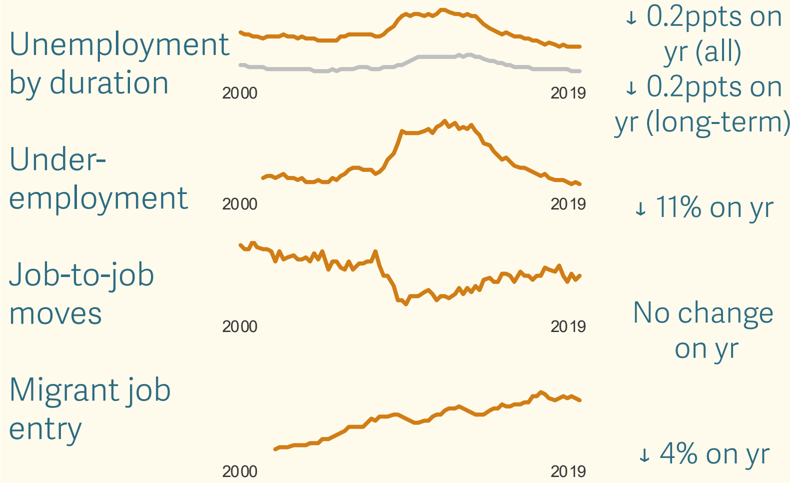
Employee earnings continue to outstrip self-employed earnings. The gap has increased slightly over the past year.

Pay growth was 0.7ppts higher, as a result of compositional effects (e.g. due to expanding jobs in high-paying occupations), than it would have been absent these effects.

Median year-on-year real hourly pay growth for employees in work over a year (both job stayers and changers) stood at 1.4% in April 2019, 0.6ppts higher than the previous year.

Both our headline measures of earnings inequality (r75:25 and r90:10) continue to fall. The 90:10 gap has closed by more than 10% over the past decade.

What's round the corner: *Pay pressures and slack*



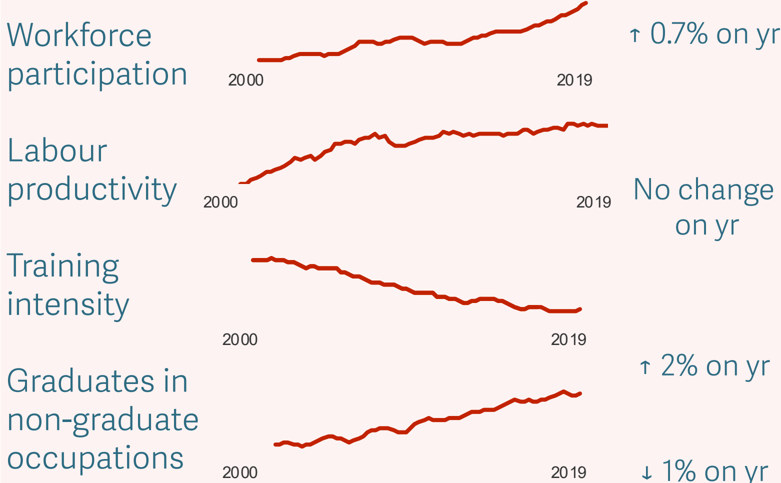
The unemployment rate fell slightly over the year to 2019 Q3, reaching 3.8%. The slowing pace of falls in the unemployment rate suggests a turning point in the labour market.

Our measure of under-employment (net hours desired by those in work as well as the unemployed) fell by 11% over the past year and is close to historic lows.

The proportion of workers voluntarily moving job (an indicator of worker confidence) is below the peak seen in 2018 Q2 but has not fallen further over the course of 2019.

The share of jobs going to new migrants has fallen by 4% over the past year and is now 7% below the 2017 peak.

What's in the pipeline: *Longer-term labour market health and efficiency*



The 18-69 year old labour force participation rate continues to rise and reached 76.4% in 2019 Q3. The largest increases have been among 50-69 year olds (up by 1.5% in the past year).

Labour productivity continues to disappoint and has not grown over the past year, having only risen 1.2% over the past four years.

While the proportion of people receiving 'off-the-job' training was slightly up over the past year at 6.8%, the long-term trend still shows a big fall in training intensity over the past 20 years.

The proportion of graduates in non-graduate roles fell slightly in the last year to 36.3% of all graduates.

Spotlight: Labour market vs the economy

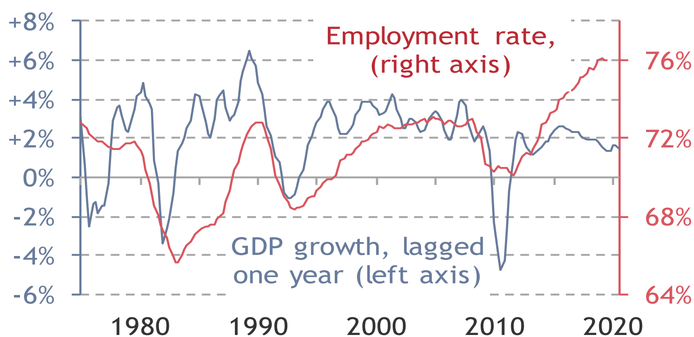
With sustained record employment, and pay growth returning to healthy levels, 2019 was a good year for the UK labour market. But you wouldn't have guessed that if you looked at what was happening in the wider economy. GDP growth slowed throughout the year (with growth on the quarter hitting zero in October), while Brexit uncertainty and global headwinds sapped business confidence, leading to stalling investment and zero productivity growth. But through it all, the labour market sailed serenely on.

Or did it? Towards the end of the year there have been signs of the labour market starting to feel the effects of the wider economic slowdown. Demand appeared to weaken, with vacancies (while high) falling steadily throughout the year. With employment growth slowing, the autumn saw nominal pay growth fall back from its summer high point.

The question is – does recent softening represent a turning point (with conditions set to worsen in 2020) or merely a settling down (with 2020 set to largely resemble 2019)?

Perhaps the strongest evidence for the former is what's happening to GDP growth, and the strength of its relationship with the labour market. Figure 4 plots 45 years of GDP growth and the employment rate. It's clear (and not surprising) that the employment rate tends to move closely with the economic cycle.

FIGURE 4: **GDP growth and the employment rate: UK**.



Source: RF analysis of ONS, *Labour Force Survey*; ONS, *National Accounts*

What's perhaps less obvious is that employment lags the wider economy by as much as a year (Figure 4 therefore plots GDP growth with a 12-month lag). This suggests businesses make decisions about hiring and firing more slowly than they experience changes in demand, potentially due to labour hoarding (where firms adopt a wait-and-see approach to avoid the costs of rehiring). This means we might expect slow growth today to bite on the labour market next year.

Exploring this more formally with a basic statistical model (a two-quarter vector autoregressive model that accounts for GDP growth, the employment rate, real pay growth, vacancies, the exchange rate, and the output gap) suggests that a scenario with annual GDP growth remaining at 1 per cent is consistent with a falling employment rate.

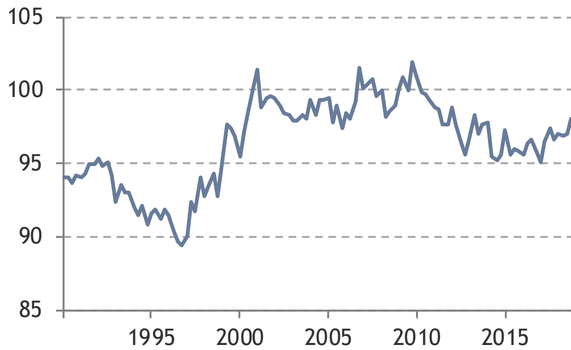
A further consistent earnings headwind has been the UK's woeful productivity growth – still flat 10 years after the crisis. In the long term this places a limit on pay growth. This doesn't necessarily mean pay growth must fall to match productivity growth next year. Pay growth can outstrip productivity growth for a time, particularly in a tight labour market, i.e. when labour is relatively powerful.

It's also true that weak productivity growth has outperformed awful pay growth since the crisis. This might lead us to conclude that there's some scope for the latter to catch-up. But there may not be much room. One way of representing the balance of pay and productivity is in unit labour costs – the labour costs associated with producing one 'unit' of output. As Figure 5 shows, these are down on 2008, but only by 2-3 per cent – not a great deal of room for catch up. Similarly, the labour share of income is roughly where it was in 2008.

The case for an optimistic outlook is simpler. Pay growth might be softening, but the employment rate is holding up, and actually ticked up to a new high of 76.2 per cent in the latest data. And even if it does start to fall, it's the level that really matters; barring something dramatic we will have a fairly tight labour market throughout 2020, which means continued pressure on pay growth. The Bank of England actually recently revised up its expectations of average nominal weekly pay growth in 2020 to 3.75 per cent. Moreover, real pay growth will be boosted by below-target inflation, set to last into 2020. And

productivity relationship runs in both directions - ongoing wage growth should help to create the productivity growth necessary to sustain it.

FIGURE 5: **Index of real unit labour costs, 2008 Q1=100: UK**



NOTES: Unit labour costs are deflated with GDP deflator.
SOURCE: RF analysis of ONS, *Labour Productivity*

The lesson to take from all this is that a slowing economy does, in the end, mean a slowing labour market, but not that the UK's labour market must inevitably have a tough 2020. The actions of policy makers, and indeed the reactions of businesses and consumers are what will decide our economic future. Reduced uncertainty, a return of investment to the UK and a more supportive global environment would make a huge difference and ensure employment remains near record highs and stronger pay growth is sustained. However, the chances of these economic tailwinds riding to the labour market's rescue are far from certain.